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Via Electronic Mail and Posting on www.nj-lcapp.com

Ms. Kristi Izzo
Secretary of the Board
Board of Public Utilities
Two Gateway Center, Suite 801
Newark, NJ 07102

Re: Additional Comments -- I/M/O the Long-Term Capacity Agreement Pilot Program ("LCAPP"), BPU Docket No. EO11010026

Dear Secretary Izzo:

Pursuant to the New Jersey Board of Public Utilities ("Board") Order dated February 10, 2011 ("Board Order") in the above captioned matter, enclosed please find a copy of the additional comments of LS Power Group ("LS Power") regarding the proposed form of the Standard Offer Capacity Agreement ("SOCA") to be used in the LCAPP. These additional comments will be posted at www.nj-lcapp.com. LS Power appreciates the opportunity to participate in this process and acknowledges that several of its proposed SOCA changes have been accepted in the current revised working draft.

LS Power includes with these comments, as **Attachment A**, a letter dated February 28, 2011, from Union Bank to LS Power and the Board, which has been actively monitoring the progress of the creation of the SOCA in New Jersey, and is considering the opportunity to provide debt capital to support new construction of needed generation ("Union Bank Letter"). MUFG Power & Utilities, Union Bank, N.A. is a recognized leader in project finance in North America, as its letter sets out in detail. In its letter, Union Bank emphasizes certain key principles for long-term contracts that must be considered as part of the SOCA to ensure that lenders and investors will deem a project financeable – principles that have been in place in the project finance markets for decades and have formed the basis for asset-based financing. These critical requirements include: (1) certainty of cash flows; (2) lender's rights to step-in to ensure ongoing performance of the generator; (3) alignment of the parties' interests to compel performance under the contract; and (4) generator liability needs to be capped up and until the point that the project is operational.

Union Bank's letter and the fundamental principles of project finance support LS Power's significant concerns that without substantial and fundamental revision as proposed herein and in

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accord with the Union Bank project finance principles, the EDCs' draft SOCA (as modified by Levitan) will not be financeable creating an insurmountable barrier to the investment of capital in new generation capacity and, therefore, will fail to achieve the objectives of the LCAPP Law to the detriment of New Jersey.

LS Power submitted a draft SOCA on February 14, 2011. On February 22, 2011, LS Power submitted its initial comments, including a red-lined version of the SOCA proposed jointly by the EDC and explanatory comments. On February 25, 2011 LS Power submitted its reply comments including a redline of the Levitan & Associates ("Levitan" or "Agent") February 23rd posted mark-up of the EDCs' February 14th draft SOCA and explanatory comments emphasizing that LS Power's proposed changes are critically necessary for the SOCA to be financeable as part of the Generator's project financing in order to be an inducement, and not an impediment, to needed generation capacity development, as required by the New Jersey legislature and for the benefit of New Jersey ratepayers.

Below, as **Attachment B**, we submit a red-lined version of the Levitan revisions posted yesterday evening to the EDCs' draft SOCA (including modifications to the security and escrow provisions and attachments). We continue to follow the Board's lead by focusing on the EDCs' draft SOCA as the starting point for a workable SOCA.¹

I. Without Substantial and Fundamental Revision in Accord with the Union Bank Project Finance Principles, the EDCs' draft SOCA (as modified by Levitan) Will Not be Financeable Creating an Insurmountable Barrier to the Investment of Capital in New Generation Capacity and, Therefore, Will Fail to Achieve the objectives of the LCAPP Law to the Detriment of New Jersey Ratepayers.

The LCAPP Law was enacted to promote the construction of qualified electric generation facilities by addressing existing barriers found in the PJM RPM to project financing for the construction of new, efficient generators, for the benefit of ratepayers. The SOCA is the means to accomplish the legislature's intent by creating a capacity payment stream and contract regime that is enforceable and financeable over its term. As the Union Bank letter makes clear, the development of generation capacity is fundamentally different in terms of financing and risk, when compared to other shorter-term agreements for the simple purchase of wholesale power. The SOCA must comport with project finance industry standards; otherwise, it will fail and the intent of the LCAPP Law will be thwarted..

Without the fundamental revision proposed herein, the EDCs' draft SOCA (as modified by Levitan) suffers from a fatal flaw – it will not be financeable. Based on our experience, and as supported by the Union Bank letter, LS Power sets out the changes to the EDCs' draft SOCA (as modified by Levitan) that a lender will require in order to finance hundreds of millions of dollars to construct the contemplated generation projects. The following changes proposed by LS Power are not "asks" or "reaches" -- the changes instead are "must haves" based on the

¹ Terms not defined herein are either defined in the draft SOCA, PJM rules, and our previous comments.

fundamental realities of the project finance markets for new generation. We have provided the necessary changes in Attachment A, as explained further below.

- Section 7.1.5 Bankruptcy: This provision will be highly scrutinized by lenders. The provision should be subject to any consent agreement with the Facility Lender, which is a standard provision in project development contracts and avoids the bankruptcy provision being the predicated for an unjustified default. We also have deleted Section 7.1.5(vii) because it unjustifiably creates a default situation for what amounts to a cross default, encumbers the lender's collateral, and disturbs the lender's ability to step in and ensure performance and, as such, is not typical of bankruptcy provisions. As Union Bank indicates in its letter:

Lenders Rights to Step-in to Ensure Ongoing Performance of the Generator – as discussed previously, lenders are relying on the cash flows received by the generator from the SOCA to commit their capital to the generator, and in the event that the lender needs to take assignment of the SOCA to perform the responsibilities of the generator, the utility cannot have a springing right to terminate the SOCA. In this instance, the lenders are taking this step so as to fulfill the ongoing obligations of the generator to preserve the commercial arrangements that are in place, and importantly, the utility is not harmed so long as a responsible party is directing the business operations of the generator. Certain of the provisions of the draft SOCA appear to give the utility a right to terminate the contract if the generators' lenders take possession of the generator's assets. Union Bank Letter at page 2.

- Section 8 Termination Events: The illegality and invalidity of the Act provision should be revised as proposed in Attachment A. Through a variety of proposed termination events, the EDCs' draft seeks to introduce risks not associated with the core purpose of the LCAPP, and therefore threaten the underlying purpose of SOCA as well as the financability of the facilities. Specifically, each and every proposed termination event adds unnecessary and uncontrollable risk to the generation development process posed by a prospective change in law. If any one of these events occur, it would result in termination of the SOCA, possibly several years after commencement of the agreement. As indicated in the Union Bank letter, no lender would accept such potential and long-term, uncontrollable risk regarding a significant asset. Indeed, the current termination events violate a number of the core project finance principles set out in the Union Bank letter including certainty of cash flow, the introduction of unreasonable risk of termination, and alignment of the parties' interests to compel performance. As stated in the Union Bank letter:

The SOCA also contained language stating that if provisions of the legislation that formed the basis for the SOCA are challenged or amended, then payments or performance under the SOCA could be suspended, or certain continued representations of the generator

would no longer be true. While there may currently be uncertainty around certain circumstances associated with legislation in New Jersey, once the SOCA is signed and effective and the generator is raising several hundred million dollars to construct their facility, the project finance market cannot accept the uncertain risk that these provisions place on the generator. Union Bank Letter at page 2.

In short, if the PJM rules are followed by the generator, then there should be no event of default or termination – the generator bears the risk of payment reductions, replacement capacity obligations and deficiency payments imposed by PJM under its rules.

The termination provision, moreover, as proposed by the EDCs is contrary to the LCAPP Law. The LCAPP Law, P.L. 2011, C. 9, as requires that the SOCA must become irrevocable upon the issuance of such order approving a SOCA (emphasis added):

- d. The board shall order the full recovery of all costs associated with the electric public utilities' resulting SOCAs, and the costs of the agent retained pursuant to subsection b. of this section, from ratepayers through a non-bypassable, irrevocable charge;
- e. ***Notwithstanding any other provision of law, each SOCA shall become irrevocable upon the issuance of such order approving a SOCA; and***
- f. ***Neither the board or any other governmental entity shall have the authority, directly or indirectly, legally or equitably, to rescind, alter, repeal, modify or amend a SOCA or an LCAPP cost rate order, to revalue, re-evaluate or revise the amount of LCAPP costs, or to determine that the LCAPP charges or the revenues to recover the LCAPP charges for such SOCAs are unjust or unreasonable; . . .***

It is our understanding that this provision mirrors provisions in Electric Discount and Energy Competition Act ("EDECA"), the 1999 New Jersey deregulation law, which were included at the urging of Wall Street to ensure the recovery of stranded costs and to eliminate future risk that a law might try to undo that recovery. As required under the LCAPP Law, we need the same certainty here in the SOCA to achieve financing for the SOCA generators.

- **Section 9 Remedies:** The EDCs' SOCA draft as modified by Levitan creates an untenable and out-of-market remedy regime. Under the EDCs' proposal, the Generator essentially always pays and its payments are tied to the market value of the contract over time, while the EDC only pays unpaid costs, with no recognition of the benefit of the bargain to the Generator (and, most importantly, to its project

finance lenders) of the capacity revenue stream over the term of the agreement. This is inequitable on its face and clearly cannot be the subject of financing. The remedies upon events of default provision must be appropriately and commercially rebalanced to reflect the realities of an agreement – the SOCA – that is intended to support new build construction of needed generation. The provision should be rebalanced in a traditional manner, taking into account gains, losses, and costs (LS Power has also proposed relevant definitions), and ensuring that payments are only owed by defaulting parties to non-defaulting parties, and not vice versa. Indeed, as Union Bank emphasizes in its letter:

Alignment of Parties' Interests to Compel Performance Under the Contract – the remedies that are in place to ensure that one counterparty doesn't have an incentive to cease performance under a contract need to be meaningful. The draft SOCA provided that a payment default by the utility would give rise to payment only of any amounts that had accrued unpaid up until the point of calculation. In order to ensure that the utility doesn't have an incentive to cease making payments if forward market conditions change from the time that the SOCA is entered into, there needs to be a meaningful termination payment that would be owed and payable to the generator. Absent such a mechanism, lenders will not have assurance that there is a meaningful penalty to compel continued performance under the contract. Union Bank Letter at 2.

These necessary revisions also must include the right to net as between the parties and within the SOCA payments, and a clear indication that the remedies are not exclusive, and the parties can seek redress in a court of law. Indeed, as set out in the Union Bank letter, liability needs to be capped up to the point that the project is operational. Therefore, the Generator's damages should be capped for an Event of Default for failure to achieve commercial operation at the amount of Construction Period Security.

- New Section 13.8 Change in the RPM (new provision): If a material change occurs in the RPM that eliminates capacity obligations, then the parties should remain bound to make the anticipated payments utilizing a market-approach to replace the RCP. *See* Section 5 of the draft SOCA submitted by LS Power. Without these critical provisions, as supported by the Union Bank letter admonitions regarding the interruption of cash flow and certainty of the terms, would be too much regulatory risk such that an eligible generator may not be able to achieve financing in the first instance. The absence of such provisions would threaten the purpose of the LCAPP to the detriment of New Jersey's ratepayers.
- Section 12 Notice of Dispute: As a result of our discussion above regarding Section 13.8, and as supported by the Union Bank letter and because they create undue and unreasonable risk for lenders, the notice of dispute provisions (12.1.2 and 12.1.3) must be deleted regarding the modification or elimination of RPM

being deemed a Dispute, such that the potential resolution might be suspension of payments or termination. As evidenced in the Union Bank letter, such unreasonable risk of cash flow interruption and potential termination would be support project financing.

II. Without the Following Changes, the SOCA Would be Saddled with Unjustified Risks Leading to an Upward Trending In Bidding and Prices Contrary to the Objectives of the LCAPP Law to the Detriment of New Jersey Ratepayers.

Without the following changes listed below, there likely would be an upward pressure on bids and thus prices in order for a SOCA generator to address risks posed by uncertainty regarding the contract term, bidding volumes, materiality, assignments and change in law. Such a result would be contrary to the intent of the LCAPP Law and to the detriment of ratepayers. Reduction of risk likely will tend to reduce prices by eliminating the need for risk premiums to be added to bids. The following provisions should be modified in order to reduce unnecessary risks found in the SOCA.

- Definitions – Conclusion Date: Has been modified to reflect that the Conclusion Date should move for any delays associated with Force Majeure events. As the Union Bank letter indicates, generation projects need certainty of cash flow and reduction of risk around cash flow. It is difficult to model and analyze cash flow when the actual term of the contract is unknown and can be compressed depending on force majeure events.
- Sections 2.3.1 and 2.3.3(b), and Section 7.1.8: The obligation of the Generator should be to cause the Capacity Facility to qualify under the RPM Rules as a capacity resource in an amount no less than the Unforced Capacity for the BRA associated with each Delivery Year, not the Awarded Capacity Amount. Moreover, supply offers for Unforced Capacity should be allowed to be higher *or lower* than the Awarded Capacity Amount, in accordance with the PJM rules for Unforced Capacity calculations. These revisions give recognition to the reality that the amount of capacity in the RPM will fluctuate from year to year above or below the Awarded Capacity Amount due to changing EFORd. Furthermore, tying this obligation to this amount is also beneficial to ratepayers as the risk of changes to EFORd are shouldered by the Generator.

As the Union Bank letter cautions, cash flow certainty and the mitigation of undue risk are key factors to ensure a long-term contract is financeable. PJM will set the Unforced Capacity level, and that is what should be available to be bid, not the Awarded Capacity Amount. Requiring the use of the Awarded Capacity Amount creates the potential for unexpected and unreasonable SOCA defaults or penalties, thereby directly challenging certain fundamental tenets of project finance, including certainty of cash flow and avoidance of unreasonable default circumstances. Moreover, a breach for such an event would disturb the lender's right to step in and ensure performance, as described in the Union Bank letter.

- Sections 7.1.3 (Breach of Agreement) and 7.1.4 (Misrepresentation) and 7.1.9 Security Default: Lenders require a materiality qualifier in such provisions in order to avoid potential events of default for non-material agreements or impacts. This follows from the fundamental tenets of project finance, that long-term contracts used for asset-based financing should ensure cash flow and reduce risk of non-material defaults or interruptions to cash flow. Moreover, a breach for a nonmaterial event would disturb the lender's right to step in and ensure performance, as described in the Union Bank letter.
- Section 10.2 Generator's Assignment Without Consent: It is industry standard and lenders expect to see that the Generator can assign or pledge without EDC consent its rights under the SOCA in connection with any financing or other financial arrangements, and that the EDC will reasonably cooperate with Generator with respect to any such financing and other financial arrangements, including but not limited to entering into with the Facility Lender a customary lender consent agreement. Without such a provision, lenders will view the SOCA as unduly restrictive and thus, will not lend, or the pool of potential lenders will be reduced, potential driving up development costs to the detriment of New Jersey ratepayers. As we cited above from the Union Bank letter, lenders are relying on the cash flows received by the generator from the SOCA to commit their capital to the generator, and in the event that the lender needs to take assignment of the SOCA to perform the responsibilities of the generator, the utility cannot have a springing right to terminate the SOCA, and the lender needs to be able to step in. Indeed, as Union Bank makes clear, the lenders are taking this step so as to fulfill the ongoing obligations of the generator to preserve the commercial arrangements that are in place, and importantly, the utility is not harmed so long as a responsible party is directing the business operations of the generator. Union Bank Letter at page 2.
- New Section 13.13 Severability: A section on severability should be added given the risk posed associated with current legal challenges to the LCAPP Law. Specifically, a provision should be added that the invalidity or unenforceability of any provision of this Agreement will not affect the other provisions hereof, and the parties will negotiate in good faith to maintain the balance of the agreement." Indeed, prior to terminating the agreement due to a change in law the parties should make every attempt reform the agreement to comply with law while keeping intact the intent of the parties with respect to their rights and duties under the agreement. Again, this is in keeping with the Union Bank letter regarding maintaining the certainty of cash flow in order to achieve and maintain project financing.

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III. Conclusion

LS Power respectfully requests that the Board adopt its suggested revisions to the EDCs' draft SOCA (as amended by Levitan). LS Power's proposal is supported by fundamental principles of project finance, as indicated in the Union Bank letter. Ensuring that the SOCA is financeable supports the goals of the LCAPP and, therefore, is in the interest of New Jersey ratepayers. These revisions, we believe, are critical to the success of the LCAPP.

LS Power welcomes the opportunity to discuss these issues further with the Board, its Staff, and other participants in this process to improve the capacity marketplace for the benefit of New Jersey ratepayers.

Respectfully submitted,



Thomas Hoatson
LS Power Group

Dated: March 1, 2011

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ATTACHMENT A

UNION BANK LETTER

Ms. Kristi Izzo
Secretary of the Board

ATTACHMENT B

**LS Power's March 1, 2011 Mark-Up
of the EDCs (as modified by Levitan), February 28, 2011 Draft SOCA**